

## LAWYERS, ACCOUNTANTS AND OTHER CAPITAL MARKET “GATEKEEPERS” COME UNDER PROSECUTORS’ SCRUTINY

by

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Over the last two years, following the scandals involving Enron, Arthur Andersen, WorldCom, and other high-profile corporations, it has been well documented that prosecutors have shifted and expanded the focus of their corporate fraud investigations. In this new era of inquiry, some have noted that prosecutors have been “feeling the heat” following their promises of last year to put all of “America’s corporate wrongdoers in jail.” *The Ex-Bosses Fight Back*, THE ECONOMIST, Apr. 12, 2003. Perhaps as a result, prosecutors have set their sights on a larger group of actors, in an effort to broadly attack a culture of perceived corporate excess. As this LEGAL BACKGROUNDER will demonstrate, two factors have come together to place a particular focus not only on corporations allegedly participating in fraudulent transactions, but also on the entities that have provided assistance to those corporations.

First, prosecutors and legal observers have indicated over the last year that there will be a new focus on pursuing the gatekeepers of the capital markets — the lawyers, accountants and other financial professionals who, although not involved directly in the scrutinized transaction, assisted the transacting company in accessing the financial markets. Second, although there had been signs that prosecutors have become wary of bringing criminal charges against an entire company or firm in the wake of Arthur Andersen’s demise, there are recent indications that corporations, including gatekeeping corporations, are still squarely in the sights of prosecutors. These two factors indicate that gatekeeping firms may face the prospect of continued prosecutorial scrutiny well into the future.

***A Renewed Focus on the Gatekeepers.*** An increased focus on targeting financial gatekeepers may seem an alarming trend to many who serve corporations in an advisory capacity, but it is not a new phenomenon. Under the tenure of now-retired federal judge Stanley Sporkin, from 1974 to 1981, the Securities and Exchange Commission’s (“SEC”) Division of Enforcement pursued a then-novel strategy sometimes referred to as “access theory.” See, e.g., Carrie Johnson and Brooke A. Masters, *Prosecutors, Regulators Step Up Pace of Auditor Probes*, WASH. POST, Jan. 28, 2003, at E1; Leo F. Orenstein and Marc B. Dorfman, *A Rule Gone Bad*, LEGAL TIMES, Nov. 20, 2000, at 36. Under this strategy, the Commission targeted lawyers, accountants and investment bankers, who provided corporations with the advice and

imprimatur of approval necessary to do business. The SEC, which had limited resources to focus on corporate wrongdoing (a problem that the Commission still finds itself saddled with in the present day), could increasingly direct its attention to these gatekeepers, mustering its finite resources to prevent violations of the law, without necessarily needing to take on the corporate actors themselves. *See* Johnson and Masters, *supra*.

Over the last year, public comments have indicated that the nation's law enforcement professionals are again targeting the gatekeepers, based on a similar theory — that major corporate fraud cannot exist without the complicity of accountants, lawyers and other professionals. An early warning of this approach came when, in a speech in December 2002, Deputy Attorney General Larry Thompson said that he was instructing prosecutors to take a “harder look” at the advice that outside professionals gave to the companies that have been implicated in corporate scandals. *See* Eric Lichtblau, *Bush Officials Vowing to Seek Tough Penalties in Wall St. Cases*, N. Y. TIMES, Dec. 19, 2002, at C1. This statement foreshadowed a number of other high-profile prosecutorial statements that have highlighted the increased willingness of prosecutors to “get tough with the financial gatekeepers of companies, [specifically] accountants, lawyers and investment bankers.” *SEC Settles with Ex-Andersen Partner in Sunbeam Probe*, THE ACCT., Feb 18, 2003, at 7.

For example, in December 2002, Stephen Cutler, current head of the SEC's Division of Enforcement, sent a strong warning to auditors. In a much-publicized speech before the American Institute of Certified Public Accountants, Cutler warned that the SEC's Enforcement Division would focus to a greater degree than it previously had on the role of auditors in corporate fraud. *See* Stephen M. Cutler, *Speech by SEC Staff: Remarks Before the American Institute of Certified Public Accountants* (Dec. 12, 2002), available at <http://www.sec.gov/news/speech/spch121202smc.htm>; *see also* Johnson and Masters, *supra*. Cutler noted that auditors play an indispensable role in granting corporations access to the securities markets, and that members of the profession could expect to be held accountable when they or their partners acted as “tools for achieving better — or more accurately, the *appearance* of better — financial results.” *Id.* (emphasis in original).

If Cutler's speech raised the eyebrows of accountants, a speech a few weeks later by Michael Chertoff, then-Assistant Attorney General for the Department of Justice's Criminal Division, caught the attention of lawyers as well. In that speech to the American Bar Association, Chertoff noted that while accountants had been in the crosshairs of prosecutors in the past year, lawyers would not be “far behind,” if they failed to apply “common sense” and instead continued to facilitate the creation of complex transactions that provide a false picture of a company's financial health. Mark Wigfield, *Top DOJ Cop Says Corporate Lawyers are Now in the Agency's Sights*, SPECIAL REPORT ON WORLD COM, Jan. 22, 2003, at 12. Manhattan District Attorney Robert Morgenthau echoed Chertoff's warning when he later stated that if lawyers do not disclose financial improprieties to either the SEC or to a corporation's board of directors, then they, as well as the corporation, will become a target of an investigation. Brooke A. Masters, *Tyco Ex-Counsel Fights Charge*, WASH. POST, Feb. 8, 2003, at E1.

New York Attorney General Eliot Spitzer, who has played a unique and highly visible role in this new era of aggressive prosecution, has sent a similar message to investment bankers. Spitzer warned that he will pursue individual cases against investment bankers who have “failed to [internalize] the notion that you've got to be truthful when you give advice to your client . . . that the analytical work cannot be subjugated to the investment banking.” *Interview: Eliot Spitzer*, CNBC: BUSINESS CENTER, May 14, 2003.

The message has been clear — financial gatekeepers face a future of scrutiny and uncertainty. And while prosecutors have focused on individual members of these firms, there are recent indications that the

corporate gatekeeping entities themselves should not feel that they are immune from criminal prosecution.

***Arthur Andersen's Aftermath.*** As has been frequently noted in the press, the Department of Justice was bitterly criticized for its decision to bring obstruction of justice charges in 2002 against Arthur Andersen. The public and press denounced the decision to prosecute the entire firm in conjunction with its work for Enron, as “heavy handed” and an unnecessary “death penalty” for the accounting firm. Elkan Abramowitz and Barry A. Bohrer, *Principles of Federal Prosecution of Business Organizations*, 229 N.Y.L.J. 3, Mar. 4, 2003. While few questioned the allegations that several members of Arthur Andersen’s management took part in shredding documents connected to Enron’s own corporate woes, many legal and financial commentators saw the destruction of a firm of 85,000 employees due to the misdeeds of a few as wasteful “collateral damage.” Carrie Johnson, *U.S. Refines Criteria For Prosecuting Firms*, WASH. POST, Feb 7, 2003, at E1. John C. Danforth, former United States Senator and Attorney General of Missouri, summed up the opinion of many when he observed that “A firm of thousands should not be destroyed by the actions of a few.” John C. Danforth, *When Enforcement Becomes Harassment*, N.Y. TIMES, May 6, 2003, at A31.

In the wake of the Arthur Andersen verdict, well-known prosecutors also seriously questioned the wisdom of prosecuting entire firms or corporations. New York Attorney General Spitzer sharply criticized the decision to indict Arthur Andersen as a firm, calling the decision a mistake and noting that the demise of the accounting firm had reduced competition among the remaining Big Four firms. *See* Andrew Hill, *N.Y. Attorney-General Spitzer Takes Aim at Individuals*, FIN. TIMES, Apr. 15, 2003. Spitzer emphasized that in addition to restitution and reform, the main goal of prosecution should be to punish the responsible individuals and not to “drive [corporations] out of business.” *Id.* Other well-known prosecutors echoed those sentiments, noting that while future charges may be brought against an entire firm in egregious cases, there would be an increased focus on the individuals working for those firms. Manhattan District Attorney Morgenthau and James Comey, the U.S. Attorney for the Southern District of New York, both indicated that in “extraordinary circumstances” or in instances where the entire “corporate culture is sick,” they would not rule out the possibility of criminally charging the entire firm. Johnson and Masters, *supra*. However, both also took pains to explain that such firms, including gatekeeper firms like Arthur Andersen, often have hundreds or thousands of employees who should not be implicated in any particular allegation of wrongdoing. *Id.*

Additionally, the Department of Justice’s January 2003 alterations to the guidelines used in federal prosecution of corporations were seen by some as indicating an increased emphasis on the prosecution of culpable individuals, rather than of entire corporations. The core of these guidelines were established in 1999 by then-Deputy Attorney General Eric Holder Jr., and were re-issued in early 2003 by now-Deputy Attorney General Thompson. *See* Memorandum from Larry Thompson, Deputy Attorney General, to United States Attorneys (Jan. 20, 2003) available at [http://www.usdoj.gov/dag/cftf/corporate\\_guidelines.htm](http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm); *see also* Abramowitz and Bohrer, *supra*. The guidelines now include a new factor not contained in the 1999 memorandum — prosecutors are instructed to consider the adequacy of prosecuting the individuals responsible for the corporation’s malfeasance when determining whether or not to pursue criminal charges against the corporation itself. *Id.* The comments explaining this newest principle note that it is important to first consider the adequacy of pursuing individuals because the “imposition of individual criminal liability may provide the strongest deterrent against corporate wrongdoing.” *Id.* Commentators believed that these principles made it clear that a corporation might well avoid criminal charges by offering up culpable individuals to the investigating prosecutors. *See* Danforth, *supra*.

As a result of these factors, it appeared that if prosecutors felt that if they could adequately address

corporate fraud by pursuing the culpable individuals, the corporation itself would be spared from an Arthur Andersen-style demise. See Alix Nyberg, *Fraud Squad*, CFO MAG., Apr. 2003, at 36. Some remarked that prosecutors were beginning to target “low hanging fruit” by preferring to prosecute individuals for obstruction of justice rather than expending the time and resources necessary to prosecute the underlying fraud. Craig D. Rose, *Sharks Still Circle in Wall Street’s Waters*, COPLEY NEWS SERV., May 12, 2003. Such an emphasis could also have been seen in the high-profile indictment, in April 2003, of Frank Quattrone, the formerly celebrated technology banker at Credit Suisse First Boston on charges of obstruction of justice and destruction of evidence. It seemed that the specter of Arthur Andersen might force prosecutors to concentrate on individual wrongdoing and spare corporations, including gatekeeper corporations, from criminal indictment and possible corporate death.

Recently, however, there have been indications that corporations may not have gotten off so easily. In a July 21, 2003 article in *The Wall Street Journal*, Deputy Attorney General Thompson, celebrating the one-year anniversary of the Corporate Fraud Task Force, “strongly disagree[d]” with the notion that “certain businesses are simply too big or economically important to be subjected to criminal prosecution, even for pervasive or serious criminal conduct by senior management.” Larry D. Thompson, *‘Zero Tolerance’ For Corporate Fraud*, WALL ST. J., July 21, 2003, at A10. Perhaps responding to critics of the aftermath of Arthur Andersen’s conviction, the Deputy Attorney General emphasized that “[w]here companies have fostered a culture of fraud and deceit . . . it is the company and managers who bear the blame for harm to employees and shareholders, not the prosecutors who are merely doing their jobs.” *Id.* While explaining that Justice Department prosecutors would continue to take into account the “real world results of prosecutorial decisions,” Deputy Attorney General Thompson also made clear that wrongdoing corporations would not be immune from facing future criminal prosecution. *Id.*

In line with Deputy Attorney General Thompson’s comments, it has recently been noted that in the six months since the Justice Department issued its revised guidelines regarding the prosecution of corporations, there has in fact been a “stepped-up effort” to criminally prosecute corporate offenders, not simply individuals. Edward Iwata, *Has Hunt for Corporate Criminals Gone Too Far?*, USA TODAY, July 22, 2003, at B01. As was the case with Arthur Andersen, such prosecutions have been described by the Deputy Attorney General and other prosecutors as potentially having a massive deterrent effect. This theory rests on the assumption that the indictment of one recidivist criminal corporation, even if that corporation ultimately collapses, will help to forestall a number of other companies from engaging in illegal or unethical behavior in the future, thereby protecting investors from greater harm. In line with that approach, legal experts have predicted that more companies than usual will be indicted in the coming months. *Id.*

***A Certain Future of Uncertainty for Gatekeeping Firms.*** These two factors — a renewed focus on the gatekeepers and an renewed emphasis on bringing criminal charges not only against individual wrongdoers, but also against corporations themselves — should render corporate gatekeepers wary. The Department of Justice, and perhaps the public as well, has begun to demand that gatekeepers act as bridge between corporations and the public, not as employees of the corporations. Even following the criticism that prosecutors faced in the aftermath of the conviction and demise of Arthur Andersen, it appears that other gatekeeping firms cannot expect to be spared from corporate criminal liability if they demonstrate a pervasive culture of wrongdoing or are implicated in large-scale fraud. As a result, not only the individual employees, but also the corporate executives of such entities, should continue to be worried about the possibility of future criminal prosecution. There may yet be a next Arthur Andersen.